

E. "SPONSORING ORGANIZATIONS" UNDER USDA CHILD AND ADULT CARE FOOD PROGRAM

**by
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1. Introduction

In recent months, the National Office has reviewed numerous applications for recognition of exemption under IRC 501(c)(3) from organizations that act as "sponsoring organizations" for the United States Department of Agriculture's Child and Adult Care Food Program. Based on our review, we have concluded that many sponsoring organizations further the exempt purposes of "lessening the burdens of government" and "promotion of health." Some sponsoring organizations, however, have been found to serve substantial non-exempt, private purposes, and have been denied recognition of exemption.

This article will identify the requirements that sponsoring organizations must meet to qualify for recognition of tax-exempt status under IRC 501(c)(3), and describe the factors used to determine whether a particular sponsoring organization qualifies. In addition, it will discuss the treatment of payments under the Child and Adult Care Food Program for private foundation classification and other purposes.

2. The Program

The Child and Adult Care Food Program (CACFP) of the United States Department of Agriculture is authorized by Congress in 42 U.S.C. 1763 et seq., and regulated by USDA in 7 C.F.R. 226.1-226.27. CACFP provides federal funds to child care and adult day care facilities to serve nutritious meals and snacks, in the form of reimbursements to participating institutions for meals served under the program.

Sponsoring organizations are specifically authorized to sponsor family day care providers that participate in CACFP. Under the statute, non-exempt family day care providers may participate in CACFP only under sponsorship of a sponsoring organization. See 42 U.S.C. 1766(d)(1). The law requires a sponsoring organization, if it is not a "public" entity, to be tax-exempt under Title 26 of the United States Code, or "moving toward that status."

CACFP has evolved from humble beginnings to a program that cost approximately \$1.1 billion in 1992. It began in 1968, when the Special Food Service Program for Children was established to operate in areas in which poor economic conditions existed or in which there were high concentrations of working mothers. Meals provided under the program were required to meet minimum nutritional standards and to be served at no cost or reduced cost to children unable to pay the full price. In 1975, eligibility was expanded to include any public or private organization providing non-residential child care, including family day care and Head Start Programs. In 1980, for-profit day care centers became eligible to participate under certain circumstances. In 1981, the age limit of eligible children was reduced to 12 years, except for migrant workers and the handicapped.

Originally, the law provided for reimbursement only if the family of the child receiving meals was eligible for free or reduced price meals. In 1981, Congress amended 42 U.S.C. 1766(f)(3)(A), to provide, with respect to family day care providers, for reimbursement of costs at a rate established by USDA, without documentation of costs and without regard to need of children receiving meals.¹ In 1987, the program was expanded to allow participation by certain adult day care centers. In 1989, Congress changed the programs name to "CACFP" and authorized extra funds for family day care sponsors to expand into low-income or rural areas.

Under CACFP, the sponsoring organization is responsible for (1) submitting applications for participation or renewal in CACFP on behalf of sponsored day care providers; (2) accepting final administrative and financial responsibility for program operations with respect to sponsored day care providers; (3) monitoring the program at all facilities under its sponsorship; (4) maintaining records required by USDA; (5) acting as "fiscal intermediary" for food service funds between the state agency and sponsored day care providers; (6) conducting pre-approval visits to each provider; (7) verifying that proposed food services do not exceed providers' capability; (8) training providers in their responsibilities under CACFP; and (9) reviewing operations to assess compliance with CACFP at least three times a year.

The sponsoring organization receives the following payments under CACFP: (1) payment for meals (which it must pay over to sponsored providers) at

¹ "Means testing" was retained only with respect to meals served to children of day care providers.

a rate established by law; (2) administrative payments; and (3) one-time start-up payments to develop or expand successful CACFP operations in day care homes. Administrative payments may be the actual expenditures of administering the program or the amount of administrative costs approved by the state agency. CACFP permits administrative payments based on the following monthly schedule:²

Initial 50 sponsored homes x \$67.00

Next 150 sponsored homes x \$51.00

Next 800 sponsored homes x \$40.00

Additional day care homes x \$35.00

3. Exemption

Operating as a sponsoring organization can further IRC 501(c)(3) purposes. A sponsoring organization under CACFP can qualify for exemption because carrying out the functions of CACFP can further exempt purposes by lessening the burdens of government. Sponsoring organizations are analogous to the professional standards review organization (PSRO) recognized as exempt under IRC 501(c)(3) in Rev. Rul. 81-276, 1981-2 C.B. 128. Rev. Rul. 81-276 reasoned that the PSRO lessened the government's burden and promoted health by assuming the task of reviewing the professional activities of health care practitioners and institutions to ensure they were appropriate for Medicare and Medicaid reimbursement. Similarly, the statute that created CACFP delegated the task of reviewing the appropriateness of services provided under CACFP and promoting the health of program beneficiaries to sponsoring organizations. Thus, the statute constitutes a clear acknowledgment by Congress that services provided by sponsoring organizations are a government burden, which is "lessened" by sponsoring organizations' activities.

CACFP sponsoring organizations are distinguishable from organizations such as the one described in Rev. Rul. 72-369, 1972-2 C.B. 245, which was held not exempt because its primary activities, providing managerial and consulting

² These are the current rates for administrative expense reimbursement, outside of Alaska and Hawaii. The rates are adjusted periodically to account for changes in the Consumer Price Index. See 58 Fed. Reg. 36, 636 (July 8, 1993).

services at cost to unrelated exempt organizations, constituted a trade or business ordinarily carried on for profit. Because CACFP services can only be provided by tax-exempt organizations, sponsoring organizations are a limited class of private organizations designated by Congress to perform a government function. See G.C.M. 39685 (Sept. 17, 1987) discussed in 1993 CPE Text, at pp. 26-27.

Serving private, non-exempt purposes can disqualify a sponsoring organization under IRC 501(c)(3). In addition to carrying out the purposes of the CACFP, a sponsoring organization must otherwise satisfy the requirements for exemption under IRC 501(c)(3), including the requirement of Reg. 1.501(c)(3)-1(d)(1)(ii) that an organization must be operated for the benefit of public rather than private interests. These requirements have caused some sponsoring organizations to be denied exemption under IRC 501(c)(3).

Some sponsoring organizations that have applied for recognition of exemption under IRC 501(c)(3) are, in essence, one-person operations. Typically, such an organization is created and controlled by an individual who is also its sole or principal employee. If there are other employees, they may be related to the controlling individual. The board of directors consists of the individual and related persons. The controlling individual's compensation is the organization's primary expense, though the organization may also pay rent for use of a portion of the individual's residence.

When an organization established to operate as a CACFP sponsoring organization is controlled by one individual or a small, related group, there is a strong possibility that the organization operates primarily for the benefit of the principals, and not exclusively for exempt purposes. Further, we have observed actual abuses in the operation of some closely controlled sponsoring organizations. Some organizations have been created to sponsor particular day care homes controlled by the individuals controlling the sponsoring organizations. Others have refused to sponsor economically disadvantaged providers. In some instances, multiple sponsoring organizations have been created to manipulate reimbursement under the CACFP per home schedule.

Criteria for determining if a CACFP sponsoring organization serves exclusively IRC 501(c)(3) purposes. In determining whether organizations that operate as CACFP sponsoring organizations serve exclusively IRC 501(c)(3) purposes, the Service has applied the following criteria:

- (1) Its governing body should be composed primarily of members of the

community who are not financially interested in its activities (i.e., persons other than employees of the organization or sponsored day care providers) or related parties.

- (2) Members of the governing body should not vote on decisions relating to their own compensation (or that of related parties).
- (3) Decisions about compensation of employees and other parties providing services to the organization should be made by the governing body.
- (4) No person receiving compensation for services under CACFP should receive compensation for services from any other sponsoring organization.
- (5) Sponsoring organizations should agree to sponsor any qualified day care provider, consistent with their capacity to provide services, and not discriminate based on income or educational level or similar factors.

These criteria are not unique to determinations involving CACFP sponsoring organizations. Rather, they have long been applied to a variety of organizations seeking recognition of exemption under IRC 501(c)(3). For example, requiring that a sponsoring organization be governed by a board of directors representative of the community served, rather than "insiders" with a financial interest in the organization's activities, is consistent with published precedents requiring that health care providers and similar organizations have a "community board" rather than a governing body dominated by financially interested individuals. See, e.g., Rev. Rul. 69-545, 1969-2 C.B. 117; compare Rev. Rul. 55-656, 1955-2 C.B. 262 (community nursing bureau qualified for exemption under IRC 501(c)(3)), with Rev. Rul. 61-170, 1961-2 C.B. 112 (private duty nurses' registry distinguished from community nursing bureau on basis that public control and support of latter demonstrated operation for public vs. private benefit).

Sole proprietorships. Some sponsors organized as sole proprietorships have applied for recognition of exemption under IRC 501(c)(3). IRC 501(c)(3), of course, provides exemption only to certain "corporations," or a "community chest, fund, or foundation," organized and operated exclusively for certain purposes. A sole proprietorship, being nothing other than the form through which an individual conducts business, cannot be recognized under IRC 501(c)(3).

4. Other Issues

Non-private foundation status. As discussed in section 2, sponsoring organizations under CACFP receive payments for meals, administrative expense reimbursements, and start-up payments. All such payments are "support" to the payee organization within the meaning of IRC 509(d). Some sponsoring organizations do not treat meal payments as support, apparently because they view themselves as "conduits" between the state or USDA and the day care providers who receive the funds. Rev. Rul. 79-142, 1979-1 C.B. 58, however, provides that the proper income tax treatment of meal payments consists of two elements: payment for food costs, which are expenses incurred by the day care provider on behalf of the sponsoring organization; and payment for the provider's labor. From this perspective, the sponsoring organization is treated as paying the day care provider, from its own funds, for the cost of food and for the provider's services. Thus, the sponsoring organization is in receipt of income and is not a mere conduit between CACFP and providers.

In determining if a sponsoring organization is other than a private foundation, administrative expense reimbursements and start-up payments are governmental grants/support, see Reg. 1.509(a)-3(g)(2) and 1.170A-9(e)(8). Meal payments are payments for the performance of the organization's exempt function, and counted as "public support" under IRC 509(a)(2), in a manner similar to medicare and medicaid payments to health care organizations, see Rev. Rul. 83-153, 1983-2 C.B. 48.

Thus, depending on what portion of the organization's support consists of grant payments, as opposed to exempt function income, the organization may be appropriately classified as publicly supported under IRC 509(a)(1) and 170(b)(1)(A)(vi), or under IRC 509(a)(2).

Form 990 filing requirement. Under Rev. Proc. 83-23, 3.01, 6, 1983-1 C.B. 687, 688, organizations normally receiving less than \$25,000 in annual gross receipts are excepted from filing Form 990. (Form 990 must generally be filed by every organization exempt from taxation under IRC 501(a), pursuant to IRC 6033(a)(1) and Reg. 1.6033-2(a)(1).) Reg. 1.6033-2(g)(4) defines "gross receipts" as the gross amount received by the organization from all sources, without reduction for any costs or expenses.

Sponsoring organizations generally report administrative expense

reimbursements and start-up payments as grants on Form 990. As discussed above, these are payments from a governmental unit having as their primary purpose to enable sponsoring organizations to provide services for the direct benefit of the public rather than to serve the direct and immediate needs of the grantor. See Reg. 1.170A-9(e)(8)(ii), 1.509(a)-3(g)(2).

Meal payments, in addition to being "support" to a sponsoring organization under IRC 509(d), are also "gross receipts" under Reg. 1.6033-2(g)(4). Meal payments should thus be included in deciding whether the organization is excepted from filing Form 990 pursuant to Rev. Proc. 83-23. If Form 990 is required, meal payments should be reported as program service revenue.

Information reporting requirements. Questions have arisen on how the information reporting requirements of IRC 6041(a) apply to payments by sponsoring organizations to sponsored day care providers. In general, IRC 6041(a) requires that an information return (Form 1099) be made with respect to certain "fixed or determinable" items of income. As discussed above, under Rev. Rul. 79-142, payments by sponsoring organizations to sponsored day care providers consists of two elements (food cost reimbursement and compensation for services), only one of which is income to the payee. The taxable amount is the amount by which the payment exceeds food costs. In these circumstances, is the reportable amount "fixed and determinable" within the meaning of IRC 6041(a)? Arguably not, where the sponsoring organization does not know the amount of the provider's food costs.³

The Service has issued several private letter rulings addressing this situation. These rulings (which may not be cited or used as precedent) indicate that a sponsoring organization need not report on Form 1099 payments distributed solely to reimburse food costs; but if the organization has direct knowledge that the amount paid to a provider in a taxable year exceeds the provider's costs by \$600 or more, the organization must report on Form 1099 the amount that exceeds the actual food costs. See, e.g., PLR 91-43-043 (July 29, 1991).

Recognizing the potential that day care providers may not report income received under CACFP unless they receive Form 1099, the Office of Assistant Chief Counsel (Income Tax & Accounting), which has technical jurisdiction over IRC 6041(a), is continuing to consider this issue. Additional guidance may be

³ Under 42 U.S.C. 1766(f)(3)(A), the day care provider need not document food costs to receive reimbursement.

forthcoming.

5. Conclusion

As this article is written, the National Office is preparing Exempt Organization Handbook instructions on the issues discussed in this article. Consideration is also being given to compliance programs targeting sponsoring organizations. We hope that uniform application of the criteria outlined will prevent the kinds of abuses described in this article, without undermining the Congressional goal in enacting and expanding CACFP, of ensuring that children in day care receive nutritious meals.